



## A Brief Analysis of HB 4831

Gary Wolfram, Ph.D.

December 3, 2013

Since January 1, 1975, the Michigan Constitution has provided an exemption from the sales and use tax on "the sale or use of prescription drugs for human use." This exemption, along with one for food not prepared for immediate consumption, was included in order to add some progressivity to the Sales Tax.

Lower income families spend a higher proportion of their income on food and prescription drugs than do higher income families. As a consequence, a sales tax on prescription drugs (and food) would be a higher burden as a percentage of income on those in the bottom of the income distribution. This is the basis for the exemption. The drug industry has evolved significantly since 1975. In particular, some drugs which are prescribed by a physician can now be obtained over the counter. The statutory exemption in the Sales Tax Act, Section 4g, currently exempts "sales of drugs for human use that can only legally be dispensed by prescription." Note that this implied definition of prescription drugs can be thought of as narrower than that implied by the Constitution. Prior to a 2004 amendment the exemption read nearly identical to the language in the Constitution. HB 4831 would return the exemption to its earlier status, including a sales and use tax exemption for over the counter drug for human use pursuant to a prescription. There are at least two reasons to allow the exemption for prescribed drugs that are available over the counter. The first is an equity argument. The original reason for exempting food and prescription drugs is that this makes the sales tax less regressive. If the doctor prescribes a drug then it makes little difference if the drug is available over the counter or must be purchased from a pharmacist. The cost of the drug will be greater as a percentage of income for low income households no matter from whom it is purchased. Exempting prescribed drugs whether over the counter or from a pharmacist fits within the spirit of the constitutional amendment.

Second is an efficiency argument. Suppose my doctor prescribes drug A for my condition and it is available over the counter. If this will be taxed at a rate of 6%, then there is an incentive to prescribe a different drug that is not available over the counter. This effect will be particularly strong for insurance companies and others that purchase large amounts of drugs for their policyholders. The tax treatment of drugs will affect the how they are dispensed, which is not an efficient use of medical resources.

Given that exempting prescribed drugs that are available over the counter fulfills the spirit and the language of the Constitution, and leads to a more efficient use of medicine, the question of the revenue impact on the State budget arises. A basic estimate, which ignores the cost of the inefficient use of drugs caused by the disparate tax treatment, requires knowledge of what percentage of prescription drugs are over the counter. The

House Fiscal Agency estimated the loss of revenue to the State at \$8.2 million, but concluded with: "The actual amount of these losses will depend on the rate at which doctors prescribe OTC drugs, and the prices of those medications, both of which are unknown."

The Senate Fiscal Agency, in its estimate of a \$12 million revenue loss assumed that "physicians provide prescriptions for roughly 30% of sales most likely to be associated with a prescription." Its analysis concludes similarly to that of House Fiscal Agency: "The actual reduction would depend on the extent to which consumers request, and physicians supply, prescriptions for over-the-counter drugs."

Michigan Department of Treasury presumed that prescribed drugs make up 20% of the over the counter sales, leading to an estimate of revenue loss of \$10 million—similar to that of House Fiscal Agency and Senate Fiscal Agency.

Estimating the effect on State revenue of the exemption change depends crucially on what percentage of over the counter sales are prescribed by a physician. A survey of three major retailers found that prescription drugs made up a very minor share of over the counter sales—significantly less than 1%. This would give a revenue estimate of less than one-twentieth that of Treasury, or \$500,000.

The Michigan Department of Community Health in their Fee-for-Service pharmacy paid \$6.7 million for over-the-counter drugs in fiscal year 2012, which would yield a revenue loss of about \$400,000. Since this represents Medicaid payments, the use of over-the-counter prescription drugs will be higher than that of the general population because the nursing home environment makes greater use of this than the general population.

The evidence strongly indicates that the revenue reduction from will be significantly lower than the estimates of Treasury, House Fiscal Agency, and Senate Fiscal Agency, as each of these agencies assume prescription drugs are a much larger share of the over the counter market than is the case. The actual revenue loss is likely to be more on the order of \$1 million, perhaps less.